

**LEGAL AND REGULATORY  
FRAMEWORK OF BUSINESS  
IN UKRAINE**

Prepared for



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<b>Table 1 Chronology of Laws and Decrees of Ukraine Affecting Enterprises in Ukraine</b>		
<b>Effective Date</b>	<b>Title</b>	<b>Number</b>
25 January 2001	Decree on the Decision of the National Security and Defense Council of Ukraine of on Measures to Bring the Economy Out of the Shadows	not available
21 December 2000	Law on National Program in Support of Small Business Development	2157-III
29 November 2000	Cabinet Resolution on Licensing the Wine and Tobacco Trade	1755
19 October 2000	Law on State Support of Small Enterprises	2063-III
30 September 2000	Cabinet of Ministers Decree on Realization of the President's Decree on Assistance in Personnel Training for the Sphere of Business (no. 849, 03 July 2000)	1358
15 July 2000	Decree on Measures on Providing Entrepreneurship Support and its Further Development	906
03 July 2000	Decree on Assistance in Personnel Training for the Sphere of Business	849
01 July 2000	Law on Licensing Certain Types of Economic Activities	1775-III
11 May 2000	Law on Special Investment Conditions in the Territory of Kharkiv	1714-111
16 July 1999	Law on Accounting and Financial Reporting in Ukraine	not available
28 June 1999	Decree on Alteration of the Presidential Decree on Simplification of Taxation System, Accountability And Reporting of Small Business Subjects (03.07.1998 ? 727)	746/99
27 June 1999	Decree on Regulation of Certain Issues Concerning the Antimonopoly Committee's Activities	741
22 June 1999	Cabinet of Ministers Resolution on Regulations of the State Sanitation and Epidemiological Inspection Service	1109
17 November 1998	Decree on Licensing Activities of Economic Subjects in the Area of Natural Monopolies	1257/98
23 July 1998	Decree on Some Measures for Deregulation of Entrepreneurial Business	817/98
03 July 1998	Decree on Simplification of Taxation System, Accountability and Reporting of Small Business Subjects	727
25 May 1998	Cabinet of Ministers Decree on State Registration of Subjects of Entrepreneurial Activity	740
22 May 1997	Law on Taxation of Company's Profits	283/97-? ?
03 April 1997	Law on Value Added Tax	168/97-? ?
11 December 1996	Cabinet of Ministers Resolution on Some Questions of the Employment in the Tax Police	1486
15 November 1996	Cabinet of Ministers Resolution on Organizing the Activity of the State Tax Administrations of Ukraine	1385
30 October 1996	Decree on Questions of the State Tax Administrations	1013
30 October 1996	Law on State Regulation of Equity Markets	448
28 August 1996	Decree on Creation of the State Tax Administration and Local State Tax Administrations	760

**Table 1 Chronology of Laws and Decrees of Ukraine Affecting Enterprises in Ukraine**

<b>Effective Date</b>	<b>Title</b>	<b>Number</b>
28 June 1996	Constitution (Fundamental Law)	
19 March 1996	Law on Regime of Foreign Investment	93/96
29 February 1996	Cabinet of Ministers Decree on Rights and Authorities of Oblast Departments of Town Planning and Architecture	267
11 November 1994	Cabinet of Ministers Resolution on the Implementation of the Procedure of Preventing Commodity Markets Monopolization	not available
26 July 1994	Cabinet of Ministers Resolution on Regulations of the State Fire Brigade	508
19 February 1994	Decree on the Regulation of Investment Funds And Investment Companies	55/94
15 December 1993	Law on Consumer Rights Protection	3682-XII
26 November 1993	Law on Antimonopoly Committee	3659-XII
20 May 1993	Cabinet of Ministers Decree on Local Taxes and Gatherings	56-93
12 May 1993	Cabinet of Ministers Decree on Conditions of Foreign Investment	not available
7 May 1993	Cabinet of Ministers Decree on Regulation on State Control and Revision Service in Ukraine	515
4 May 1993	Cabinet of Ministers Decree on State Labor Protection Committee of Ukraine	328
21 January 1993	Cabinet of Ministers Decree on Collecting Unpaid Taxes and Fees	8-93
18 February 1992	Law on Restriction of Monopolism and Prevention of Unscrupulous Competition in Entrepreneurship	2132-XII
12 December 1991	Customs Code	1970-XII
19 September 1991	Law on Corporations (also translated as the Law on Companies, Law on Business Associations and the Law on Economic Associations)	1576-XII
18 September 1991	Law on Investment Activity	1560-XII
<b>24 August 1991</b>	<b>Declaration of Independence of Ukraine</b>	
25 June 1991	Law on Taxation System	1251-XII
18 June 1991	Law on Equity and Stock Exchange	not available
27 March 1991	Law on Enterprises	887-XII
07 February 1991	Law on Property	697-XII
07 February 1991	Law on Entrepreneurship	698-XII
4 December 1990	Law on State Tax Service	509-XII
<b>16 July 1990</b>	<b>Declaration of the State Sovereignty of Ukraine</b>	not available
1988	Soviet Law on Cooperatives	not available
to be determined	Soviet Law on the Self-employment of USSR Citizens	not available

NOTE: This table is by no means a comprehensive list of all laws and regulations affecting enterprises in Ukraine. The table contains the most significant laws and decrees that UI encountered during its research.

## **LEGAL AND REGULATORY FRAMEWORK OF BUSINESS IN UKRAINE**

### **HISTORY**

The Soviet Law on Cooperatives of 1988 provoked a massive increase of employees at cooperatives, which benefited from high wages and low taxes. Cooperatives provided a foundation for business development in Ukraine. They were mostly concentrated in industry and construction (Petrovksy 2001).

In February 1991, Ukraine joined Russia, Uzbekistan, Kazakstan, Latvia and Belorussia in complementing the USSR Act on General Principles of Citizen Enterprise of May 1991 by passing the Law on Entrepreneurship. The USSR Act authorizes the formation and operation of collective and private enterprises. This was the first official document since the era of the New Economic Policy in the 1920s that permits, or even mentions, legal private enterprises. The related law of Ukraine boldly states that, "Entrepreneurs shall have the right to make decisions and independently conduct any business activity not contrary to effective law," (Article 3). The law authorizes various freedoms for entrepreneurs, guarantees their safety and that of their workers, defines state support for enterprises and guarantees free competition among entrepreneurs. The Law's provisions are impressive, especially considering that entrepreneurial activity was still defined as criminal in Soviet legislation that was still effective when the Law was approved (Russica 1991).

Ukraine declared its sovereignty in July 1990 and its independence in August 1991. In September 1991, its parliament adopted two laws that affirm the applicability of Soviet and Ukrainian laws passed prior to the country's independence, so long as they do not contradict the Constitution of Ukraine or other laws adopted since independence. As a result, Ukraine is party to the Universal Copyright Convention (Geneva 1952) and other international agreements to which the Soviet Union was party. In 1992, Ukraine joined the Paris Convention for the Protection of Industrial Property of 1883 (amended in 1967 and 1979).

Also in 1992, the Cabinet of Ministers of Ukraine established a working group to develop the Commercial Code of Ukraine. The expert members of the group wrote a draft code that circulated among government officials, academics and domestic and international technical experts before it was presented to the Cabinet of Ministers in December of 1995. A few months later, the draft was submitted to the Verkhovna Rada (Supreme Council).

The Verkhovna Rada finally discussed the draft Code in December 1998, when it decided that a temporary committee should reconcile the draft Commercial Code with the draft Civil Code. The draft Civil Code emphasizes private interests, including individual property ownership, while the draft Commercial Code follows the lead of the Ukrainian Constitution, in particular Article 13 that gives the state responsibility for the social direction of economic development.

### **LEGAL FRAMEWORK**

The legal framework of business and its frequent changes are routinely cited as obstacles to enterprise development in Ukraine (MSI 1999; EIU 2000; IFC 2000; UI 2001; IFC 2001). By some estimates, the legal framework is formed by no less than thirty-three national laws, twenty-two cabinet resolutions and fifteen presidential decrees (Petrovksy 2001).

While businesspeople in Ukraine await the reconciliation and enactment of the proposed Commercial Code, they may create their businesses under either the Law on Enterprises or the Law on Corporations. The Law on Enterprises provides a very basic legal foundation for business in Ukraine, and an even more basic foundation for advanced economic relationships, such as holding companies and joint ventures. The Law on Corporations defines in much more detail the relationships and responsibilities of multiple owners of a business, so most firms are organized according to this law's provisions (Baker & McKenzie 2001). Municipal enterprises are fully addressed by neither of these laws (nor any others), and are discussed in a separate section at the end of this chapter.

## ENTERPRISES

The 1991 Law on Enterprises legally defines an enterprise as an independent economic statutory subject that has rights of a legal entity and carries out production, research and development and commercial activities directed at the generation of profit. According to the Law, the financial resources of enterprises consist of: profit; capital allowances; revenues from securities sales; and employee contributions.

Interference by state and public organizations and political parties in the activities, economic and otherwise, of enterprises is prohibited except in cases provided by the state.

The law defines the following types of enterprises:

- private enterprise based on property of a physical person;
- collective enterprise based on property of the work force of the enterprise;
- economic society (corporation);
- enterprise based on property of a civil association;
- municipal enterprise based on property of a certain territorial community;
- state enterprise based on state property.

The Law permits and defines various types of coordination among enterprises. *Associations* are contractual joint ventures created with the aim of permanent coordination of economic activities. *Corporations* are contractual joint ventures created on the basis of a combination of productive, scientific and commercial interests. In a corporation, some responsibilities of individual enterprises are transferred to a central administration. A *Consortium* is a temporary contractual joint venture that includes the combination of production and bank capital in pursuit of a common goal. A *Concern* is a contractual joint venture that is completely, financially dependent on one enterprise or a group of enterprises. Enterprises may merge with, and spin off from, other enterprises.

The Law defines enterprise property as fixed assets and current assets, including:

- money and material contribution of promoters;
- sales revenues;
- income from securities;
- bank and other credits;
- investments and budget subsidies;
- proceeds from privatization of property;
- acquisition of other enterprise property; and
- grants or donations from organizations and citizens.

## **CORPORATIONS**

The Law on Corporations (also translated as the Law on Companies, Law on Business Associations and the Law on Economic Associations) defines and regulates companies, which may be formed by domestic and foreign enterprises, organizations and individuals. State-owned enterprises may not be party to corporations.

### **General Provisions (Articles 1 - 23)**

The law requires corporations to register as legal entities by submitting their constituent documents to the Antimonopoly Committee of Ukraine. The documents must include the type of association, its field of work, its founders and participants and management bodies and procedures. The documents must also include information on the number and division of shares and shareholder voting procedures.

The law guarantees shareholders the right to participate in the management of their corporation and to receive dividends on their investment shares. It also requires corporations to provide to its shareholders minutes of management meetings and annual balance sheets and activity reports. The law requires corporations to maintain accounting records and submit them to state statistics committees. Corporations whose turnover does not exceed 250 tax-free minimum-wage incomes must be audited every three years.

The law clearly identifies corporations as the owners of assets assigned to them by their founders and shareholders. These assets can include monetary, material and intellectual property, as well as rights and concessions.

The law requires corporations to maintain reserve funds of at least twenty-five percent of their equity funds. Annual allocations to the reserve fund must be at least five percent of net income. Corporations may increase their equity funds only after all shares are fully paid. Corporations may reduce their equity funds, but not over the objections of their creditors.

Corporations may be terminated when they achieve their stated goals, by decision of their highest management body, by decision of a court or by other grounds established by the corporation's constituent documents. In cases of liquidation, a special committee receives authority over all aspects of corporation management. Within three days of its appointment, the liquidation committee must publish information on the procedure for creditors to submit claims, and prepare for the settlement of all corporate accounts. Within six months after publication of the liquidation notice, and once the corporation has settled with its staff, banks, bond-holders and other creditors, the corporation's remaining assets are distributed among its shareholders and founders. Assets assigned to a corporation by its founders should be returned as they were received, without compensation.

### **Joint Stock Companies (Articles 24 - 49; 65)**

Shareholders of joint stock companies are liable for corporate commitments within the limit of their investments (shares). Shareholders may choose to accept additional liability up to an amount stipulated by the company's statute, and in proportion to their shares. In this case, the company is a "joint stock company with additional liability" but resembles a joint stock company in every other way (Article 65).



The starting equity fund of a joint stock company must be equivalent to at least 1,250 annual salaries at minimum wage. Joint stock companies may be open or closed. Shares of open joint stock companies may circulate through subscription offers and on stock exchanges. Shares of closed joint stock companies are distributed only among company founders, and may not publicly circulate.

The structure of joint stock companies includes a management board, an observation council and a financial review committee. Members of the observation council may not be members of the management board. The management board is accountable to the company's observation council and its shareholders, is headed by a chairperson and oversees the daily operations of the company. The chairperson may act on behalf of the company without prior authorization. The chairperson must organize the keeping of the minutes of all management board meetings, which should be available to any shareholder at anytime. The financial review committee is elected from among the company's shareholders. The work of the financial review committee may be authorized by the general assembly, observation council, its own initiative or by request from holders of at least ten percent of shares.

Joint stock companies have the right to issue bonds and other securities. The founders of joint stock companies must hold at least twenty-five percent of the company's equity fund for at least two years. Joint stock companies are prohibited from issuing shares to cover losses.

Joint stock companies must publicly announce opportunities to subscribe to share and bond issues. The announcement must include information on the firm, its operations and founders, the types and characteristics of its shares, the company's assets, its accountant and bank, date of shareholder meeting and other information. Share subscriptions may not exceed six months. Purchasers of the shares must deposit with the company at least ten percent of the value of the shares received, and at least thirty percent by the time of the following constituent assembly. In a closed joint stock company, founders must have at least fifty percent of the value of their shares on deposit by the following constituent assembly. If the company sells less than sixty percent of its shares during the subscription, the company is considered not established, and its founders must refund the shares purchased.

A shareholder meeting must be called within two months after termination of a subscription to shares. Shareholder meetings are competent if individuals who own at least sixty percent of the company's shares, or their representatives, are present. If a company fails to gather the necessary representation, then it is considered not established. Competent shareholder meetings may decide on the following issues:

- Adoption of the decision to establish the company;
- Adoption of the company's statute;
- Increase or decrease of the company's equity fund in response to subscriptions;
- Election of the observation council and executive and controlling bodies of the company;
- Affirmation of agreements concluded by the founders prior to establishment;
- Privileges for the founders;
- Approval of in-kind contributions;
- Other issues identified by the company's statute.

Shareholder voting is conducted on the principle of one share, one vote. Most decisions may be concluded on the basis of a simple majority, but the following decisions require support from holders of at least three quarters of all shares:

- Establishment of the company, its subsidiaries, branches and representatives;
- Election of the company's observation council;
- Executive and controlling bodies of the company; and
- Privileges and powers of the founders.

After shareholders fully pay for their shares, a joint stock company may increase its equity fund by issuing new shares, exchanging bonds for shares or increasing the nominal value of shares. Shareholders have priority rights to purchase new shares. An increase of one third or less may be authorized by the company's management board, provided such a procedure is outlined in the company's statute. Similarly, a joint stock company may reduce its equity fund by decreasing the nominal value of its shares or by purchasing and nullifying shares. When changing its equity fund, a joint stock company must issue a public announcement that identifies the following:

- Rationale and procedure for change;
- Draft changes to company statute;
- Details on the shares issued or nullified;
- Related shareholder rights;

The general assembly is the highest authority within a joint stock company. A competent general assembly requires the presence of individuals owning at least sixty percent of outstanding shares, or their representatives. All shareholders may participate in general assemblies, regardless of the number of shares they own. Management officials may participate in general assemblies, but their votes do not count.

Generally assemblies must be announced at least forty-five days in advance. Any shareholder may propose additions to the agenda for the assembly at least forty days in advance. A general assembly has no right to decide on issues not included in its agenda. Companies must hold general assemblies at least once each year. Extraordinary assemblies should be called in case of non-solvency of the company or recommendation by the observation council. An extraordinary assembly also should be held if it is called for by holders of more than twenty percent of outstanding shares. If the company management does not respond to such a call, the shareholders are free to organize an extraordinary assembly themselves.

General assemblies decide on the following issues:

- Main directions, or strategies, for the company;
- Approval of corporate plans and reports on their progress;
- Introduction of changes to the company statute;
- Election and recall of members of the company's observation council;
- Election and recall of members of the company's financial review committee;
- Approval of annual reports on the activity of the company, its subsidiaries and representatives;
- Approval of reports and conclusions of the financial review committee;
- Order of profit division and loss coverage;

- Establishment, reorganization and liquidation of subsidiaries and representatives, and related statutes;
- Responsibilities of the company's officers;
- Corporate rules and internal procedures;
- Repurchase of shares;
- Compensation for company officials and those of its subsidiaries and representatives;
- Approval of agreements on sums of money that exceed the limits identified in the company statute; and
- Approval of decisions to liquidate, appointment of liquidation committee and liquidation balance.

Most decisions may be concluded on the basis of a simple majority, but the following decisions require support from holders of at least three quarters of all shares:

- Change in the company statute;
- Discontinuance of association activity;
- Establishment and discontinuance of subsidiaries, branches and representatives.

### **Full Partnership (Articles 66 - 74)**

Owners of a full partnership are jointly responsible for the company's commitments with all of their personal property. The statute of a full partnership must state the amount of shares to be held by each owner, as well as other investments and contributions, whether in-kind or monetary.

A full partnership is managed by all of its owners, but they may choose to delegate responsibilities to one or more owners by jointly signing an authorization for such delegation. Owners and managers must disclose information on all of their actions that affect the firm. An owner may sell his shares to a third party only by agreement of all the owners. Owners are prohibited from engaging in activities that are in competition with the aims of the firm.

If a partnership was established for an undetermined amount of time, an owner may leave at any point, as long as three months' notice is given to the other owners. If a partnership was established for a determined amount of time, an owner may leave only for valid reasons and with six months' notice. The partnership should pay the leaving owner his or her portion of its income for the year in which the owner leaves. The partnership also should return any assets that were provided by the leaving owner in their original form and without compensation.

The creditors of an indebted partner who has insufficient funds to repay his or her debts may demand liquidation of the partnership, or separation of the debtor partner's share. The other partners may defensively separate a debtor partner's share of the company as well.

When a partnership is liquidated and its assets are insufficient to cover its debts, all of the partners are jointly responsible with all of their personal property. If one partner pays all of the outstanding debts of the partnership, he or she may legally require reimbursement from the other partners.

### **Limited Partnership (Articles 50 - 64)**

Shareholders of a limited partnership are liable for the company's commitments only up to their investments (shares). The statute of the partnership must state the amount of shares to be held by each owner, as well as other investments and contributions, whether in kind or monetary. A limited partnership's equity fund must be equivalent to at least 625 annual salaries at minimum wage. The shareholders must deposit at least thirty percent of the value of their shares with the company prior to registration, and must fully pay for their shares within one year of the company's registration.

Shares of limited partnership are not traded on the open market, but a partner may sell his shares to other partners, third parties and the company itself. Other partners have priority rights to purchase another partner's shares, in proportion to their current ownership shares. Third parties and the company may purchase company shares only after they are fully paid. If the company purchases shares, it must sell them within one year.

A limited partnership may increase or reduce its equity fund, but no sooner than three months after registration, and not without notice of at least three months. When a partner leaves the company, the company must reimburse his or her share of the company after the adoption of the annual report and within twelve months of the partner's leaving. If an individual partner's assets are insufficient to cover debts, his or her creditors may demand the separation of that person's share of the partnership.

The supreme authority in a limited partnership is the assembly of owners, including all partners and/or their representatives. The weight of the partners' votes are proportional to their shares. An assembly is competent if individuals representing at least sixty percent of the company's shares are present, unless the assembly is to decide on issues requiring unanimity (see below). The assembly of a limited partnership has basically the same function and competency as a general assembly of a joint stock company, with the addition of:

- Determination of the amount, form and order of additional contributions;
- Decision to purchase shares from a partner; and
- Exclusion of someone's participation in the company.

Unanimity is required for decisions on the company's plans and reports on their progress, changes in the company statute and exclusion of someone's participation in the company. Other decisions require only a simple majority, unless otherwise stipulated in the company statute. Any partner may demand consideration of an issue at the assembly, provided he or she proposes it at least twenty-five days in advance of the meeting. The head of the assembly is required to keep minutes of all meetings, and to make them available to any partner upon request. Assemblies must be held at least twice each year. In case of insolvency or other urgent matters, an extraordinary assembly should be called. Partners who hold at least twenty percent of the company votes may demand an extraordinary assembly, and may call one themselves if the head of the partnership or assembly has not responded after twenty-five days.

The executive body of a limited partnership is its board of directors headed by a general director, or an individual director. The board of directors has no right to obligate the partners to any actions. The general director or individual director may not be the head of the company's assembly. The financial review committee of a limited partnership is elected from its owners, and must include at least three people.

### **Mixed Partnership (Articles 75 - 83)**

There are two types of owners of a mixed partnership: partners, who are liable for the company's commitments with all of their personal property; and shareholders, who are liable only for their investments (shares). In almost every other aspect, a mixed partnership is the same as a full partnership. A mixed partnership's statute must identify the amounts and types of shares to be held by each partner and shareholder.

In case of liquidation, shareholders have priority over partners in regaining their investments. The shareholders may not own more than fifty percent of the company's assets, or interfere with the activity of the partners. Participants in a mixed partnership must pay at least twenty-five percent of the price of their shares before registration of the company. If all of the company's partners leave the firm, the firm ceases to exist. If only shareholders leave the firm, the company may be transformed into a full partnership.

### **MUNICIPAL ENTERPRISES**

Ukraine's legislation incompletely defines the legal status of municipal enterprises. The Soviet Ukraine Law on the Local Radas of People's Deputies and Local Self-government of 1990 established municipal enterprises by introducing the communal form of property. The Law on Property of 1991 defined communal property as a form of state property, thereby creating state municipal enterprises and incorporating them within the legal framework of state enterprises.

Article 142 of the Constitution of Ukraine, enacted in 1996, states:

Movable and immovable property, incomes of local budgets, other money, land, natural resources owned by territorial communities of villages, settlements, cities, city districts as well as objects of their joint ownership managed by district and regional councils shall be the material and financial basis of local self-government.

This marked the separation of communal and state property and was intended to end state ownership of municipal enterprises. The text is repeated in Paragraph 3, Article 16 of the Law on Local Self-government, which also assigns complete ownership and management rights for municipal enterprises to appropriate oblast and rayon councils. Other articles throughout the law reinforce these municipal rights and authorities. However, the Law on Property still has not been amended, so its Article 20 continues to assign communal property to the jurisdiction of the state (Grynyuk 1999).

## **REGULATORY FRAMEWORK**

### **REGISTRATION**

All businesses, including sole proprietors, are legally required to register as subjects of entrepreneurial activity. The requirements are found in the Law on Enterprises, the Law on Corporations and the Cabinet of Ministers Decree Confirming Regulation of State Registration of Entrepreneurial Subjects. There is no national registration agency; firms register the local administration of the territory in which they are situated by submitting their statutes and other official documents, such as a copy of the lease for their premises. Once it receives the required documents, the local administration should register the company within five days. After registering with the local administration, companies also must register with the tax administration and other agencies (Baker & McKenzie 2001).

According to the Cabinet of Ministers Decree Confirming Regulation of State Registration of Entrepreneurial Subjects, state registration bodies may cancel enterprise registrations under the following circumstances:

- statutory documents are acknowledged to be void or contradictory to the legislation;
- undue notification about changes of name, organizational form, type of ownership, location;
- acknowledgement of bankruptcy; and
- accounting documents are not submitted to tax administration within a year.

### **LICENSE**

In the mid-1990s, the licensing process was a major administrative barrier for enterprises in Ukraine. Beginning in at least 1997, the central government attempted to streamline and improve the licensing system. Efforts included amendments to the Law on Entrepreneurship and passage of the Law on Licensing of Certain Types of Economic Activity, which includes a list of specific operations requiring a license, limited mostly to activities that are potentially harmful to health and environment (the list is included as Annex 2).

The law established a special licensing agency to maintain a single license register. Licenses are issued by a variety of government agencies, depending on the type of license. Most of these agencies delegate their functions to local administrations that directly interact with the businesses requiring licenses. Licensing bodies conduct planned annual audits and unplanned audits, as appropriate. Since establishment of the new licensing regime, the time spent on obtaining licenses has decreased as a result of these efforts (from 1997 to 1998, the average time required to obtain a license fell from 35 to 14 days). However, the procedures and administrative arrangements among ministries and their local branches and local governments required by the new Law have not yet been implemented (MSI 1999, 41; IFC 2000, 17; IFC 2001, 63).

### **PERMIT**

Unlike registration and licenses, permits are unregulated by national legislation, subject only to the rules and procedures of oblast departments and agencies. For this reason, the permit process is one of the most opaque and unpredictable types of business regulation in Ukraine. Enterprises often do not know whether or not they require permits for their activities, so the process often involves obtaining permission from local authorities to engage in certain activities, whether or not

official permits are required. The opaque and unregulated nature of the process provides a moral hazard, and even incentives for extortion, for local officials (IFC 2001, p. 60).

Permits are most often required by the Fire Brigade, Sanitary and Epidemiological Service, and the Health, Safety and Environment Department. These agencies, especially the fire and sanitation departments, also are among the most frequent inspectors of businesses in Ukraine, leading to the conclusion that the permit-inspection linkage creates a fertile ground for corrupt officials (IFC 2001; UI 2001).

## **INSPECTION**

The Presidential Decree on Measures for the Deregulation of Entrepreneurial Business assigns authority for ensuring the financial and economic activities of entrepreneurial subjects to a number of supervisory bodies, including:

- State Fire Inspection;
- Labor Protection Committee;
- Customs;
- Sanitation agencies;
- State Veterinary Control;
- State Committee of Ukraine for Consumers Rights Protection;
- State Control of Prices;
- State Architecture and Construction Inspection;
- Committee of Ukraine for Standardization, Metrology and certification.

Neither these agencies nor any other executive authority may restrict entrepreneurial activities unless such restriction is directly provided by legislation. The decree authorizes several supervisory bodies to conduct field audits of entrepreneurial subjects within their respective spheres of responsibilities. The State Committee for Regulatory Policy and Entrepreneurship oversees audits performed by supervisory bodies. These supervisory bodies, the source of their authority and the activities subject to their supervision are summarized in the Table 2.

**Table 2 Supervisory Bodies of Business in Ukraine**

<b>Supervisory Body</b>	<b>Source of Authority</b>	<b>Objects of Inspection</b>
Antimonopoly Committee	Law on the Antimonopoly Committee	Noncompetitive practices, mergers and acquisitions, registration of corporations
Consumer Protection Committee	Law on Consumer Rights Protection	Adherence to quality and price regulations
Customs authorities	Customs Code	Payments of entry duties, excise duties and VAT on imported goods
Fire Brigade	Cabinet of Ministers Resolution on Regulations of the Fire Brigade	Adherence to fire safety regulations
Labor Protection Committee	Cabinet of Ministers Decree on the Labor Protection Committee	Adherence to labor law and regulations
Licensing Bodies (various)	Law on Licensing of Certain Types of Economic Activity	Adherence to conditions of licenses
Tax authorities	Law on State Tax Service	Payment of taxes, dues and fees to budget and state target funds
Sanitation and Epidemiological Inspection Service	Cabinet of Ministers Resolution on Regulations of the Sanitation and Epidemiological Inspection Service	Adherence to health and sanitation regulations
State Control and Review Service	Cabinet of Ministers Decree on Regulations of State Control and Review Service	Use of public funds, whether loans, grants or contracts



The Decree authorizes planned and unplanned field inspections. Planned inspections must be included in the work plans of appropriate supervisory bodies. Unplanned inspections are authorized only if one or more of the following applies:

- a cross audit reveals subjects violated laws;
- subjects have not submitted obligatory reporting documents on time;
- subjects have reported invalid data in obligatory documents;
- subjects have complained that supervisory body officials violated laws during planned or unscheduled audit;
- it is necessary to check statements received from the person who had legal relations with the entrepreneurial subject in case the subject does not provide explanations and obligatory written inquiry of the supervisory body during first three days after he has received the inquiry;
- the enterprise is being reorganized (liquidated); and/or
- the Cabinet of Ministers of Ukraine determines an unscheduled audit is required.

### **Tax Inspections**

According to the Law on State Tax Administration, the tax militia, or tax police, have the right to inspect any type of enterprise, regardless of the form of ownership. They have rights of access to any financial documents, premises of production, warehouses and trading facilities so long as they are used in the generation profit. The tax police may require elimination of revealed infringements, suspend bank account operations and repossess documents proving concealment or understatement of taxation objects. Tax police also may apply penalties and administrative fines to enterprises that are found to violate laws or regulations.

According to several surveys of businesses in Ukraine, the tax police conduct by far the most inspections of any regulatory agency in Ukraine. Tax inspections have been, and continue to be, named by businesspeople of Ukraine as major obstacles to business development (MSI 1999; EIU 2000; IFC 2000; UI 2001; IFC 2001).

The breadth of the tax militia's power mainly is a result of its history. Ukraine established its state and local state tax administrations by presidential decree in 1996. Subsequent decrees subordinated to those tax administrations the militia forces within the Ministry of Interior that were used to investigate criminal concealment of taxable incomes. The militia forces were, in fact, transferred as a whole unit to the tax administrations, but their competencies were not redesigned to complement their new administrative positions (Golovan 1998). For this reason, the tax police's functions are not limited to issues of taxation. For example, they are empowered to check products to ensure their shelf lives have not expired, though this task is more appropriately performed by consumer protection groups or industry itself (Petrovsky 2001).

### **TAXATION**

The original legal basis for taxation of enterprises is found in the 1991 Law on Taxation System, which authorizes the government to collect the following taxes: turnover tax, excise tax, a surplus value tax, export-import tax, custom duties, tax on owners of transportation, tax on collective farm workers' wages, payment for use of land, payment for use of natural resources, a forest tax, an ecological tax, and a profit and income tax. On average, companies pay 11 national taxes and fees, totaling approximately twenty-four percent of gross sales. The burdensome and confusing

tax system is routinely cited as a major obstacle to enterprise development in Ukraine, and is one of the main incentives for concealed sales revenues (estimated by the 2001 IFC Survey as 16 percent) and bribes (MSI 1999; IFC 2000; IFC 2001; UI 2001). The most significant and clearly defined corporate taxes are on profit and value added.

### **Profit Tax**

During 1992-1994, the government taxed the dokhod of enterprises, which is similar to profit, but does not deduct the costs of salaries and interest on long-term borrowing. Since 1997, the Law on Taxation of Corporate Profits has governed business taxation. The law established a basic tax rate of 30 percent, a tax rate of 45 percent for intermediary activities and one of 60 percent for gambling activities (Baker & McKenzie 1997). The Law on the State Budget proposes funding for the Tax Administration based on the amount of taxes and duties it collects, thus creating a moral hazard for the inspectors (Petrovsky 2001).

### **Value Added Tax**

The Law on Value Added Tax (VAT) requires additional taxes from legal entities that have sold goods in excess of 3,600 annual salaries at minimum wage or who trade internationally or with a non-resident entity. Sales and imports of goods and services are subject to VAT; the following activities are not subject to VAT:

- Sales of securities;
- Lease payments;
- Property pledges;
- Insurance provision; and
- Purchase of company shares (even if they are not in the form of securities).

The law establishes a rate of twenty percent to be applied to the contractual value of goods and services, including excise taxes, import duties and other related payments. A rate of zero percent is levied on goods and services exported from Ukraine (Baker & McKenzie 2001).

### **Small Enterprise and Entrepreneur Taxes**

The Presidential Decree on Alternation of the [Previous] Presidential Decree on Simplification of the Taxation System, Accountability and Reporting for Small Business Subjects, No. 746/99 from 28 June 1999 established the integrated system that permits small enterprises and entrepreneurs to pay either a single or simplified tax, which exempts them from a variety of taxes and fees established by the Law on Taxation. According to the Decree, the *single tax* is available to individual entrepreneurs who operate without creating a legal entity, have ten or fewer employees and whose annual sales revenue is UAH500,000 or less. Local councils determine the single tax rate, within the legally defined parameters of UAH20 and UAH200, based on the types of activities to be taxed. They pay their single tax to the State Treasury of Ukraine, which then distributes the revenues in the following manner:

- 43% to the Oblast budget;
- 42% to the Pension Fund of Ukraine; and
- 15% to obligatory social insurance.

The *simplified tax* is available to enterprises with fifty or fewer employees, and provides a choice of one of the following rates:

- 6% of sales revenue excluding excise duty where VAT is paid separately; or
- 10% of sales revenue, excluding excise duty where VAT is included.

The simplified tax is paid to the State Treasury of Ukraine, which then distributes the revenues in the following manner:

- 20% to the State Budget of Ukraine;
- 23% to the local budget;
- 42% to the Pension Fund of Ukraine; and
- 15% to obligatory social insurance.

According to Articles 5 and 6 of the Decree on taxation, sole proprietors who operate in marketplaces and pay marketplace fees may choose to pay a *fixed tax*. The amount of the fixed tax is from 20 to 100 hryvnias per month. The amount increases by fifty percent for each additional employee. Individuals that choose to pay the fixed tax may have no more than five employees and may not have recorded income that is equivalent to more than 7,000 annual salaries at minimum wage.

The State Treasury of Ukraine receives revenues from all business income taxes, irrespective of the taxation system used. Local governments determine the rates of only a few taxes and fees that affect businesses. The Cabinet of Ministers Decree on Local Taxes and Gatherings, No. 56-93 from 20 May 1993, limits the advertising tax to 0.1% for a single advertisement, 0.5% if the advertisement is to be displayed for a long period of time. The same Decree limits sales tax on imported goods to 3%. Changes in other business taxes must be effected at the national level.

## **ACCOUNTING AND FINANCIAL REPORTING**

The Law on Accounting and Financial Reporting, passed in July 1999, regulates business accounting and financial reporting in Ukraine. Article 4 of the law outlines the guiding principles of standard accounting in Ukraine. They generally correspond to the International Accounting Standards. The law requires businesses to maintain balance sheets, reports on financial results, cash-flow and private capital and explanatory notes to those reports. The law requires the annual publication, by at least 1 June, of financial reports on joint stock companies and financial institutions. The law also requires holding companies to report the financial performance of their subsidiaries.

The 1999 law is ambiguous and faulty in some respects. For example, it directs businesses to use the principle of historical cost in valuing company assets. However, this is impractical when market prices are in reality quite different from historical costs and when market prices cannot be derived from balance sheets. Investment companies have begun using market prices to assess their portfolios. There is a need to more clearly define accounting procedures such as this.

Another gap in the legal framework of business relates to financial reporting. Since 1998, commercial banks have transferred data on finance and statistics, including data on their clients, to the central bank. However, the central bank has no legal authority or procedure to obtain similar information from other financial institutions, such as credit unions and insurance companies (Synkova 2000).

## **INFORMAL SECTOR**

The informal sector of Ukraine is very large, even by official estimates. According to the National Bank of Ukraine, 52% of the nation's money supply circulates without the banking system. Informal transactions account for 67% of net profit in the financial and banking sector (Kniazhansky 2001).

Several factors contribute to a large informal sector in Ukraine. These include the complex and ever-changing legal environment for business, corruption, lack of a stable currency, trade regulations and a tradition of barter. The government has increasingly recognized and admitted problems that the informal sector presents, and recently changed its approach to encouraging the formalization of economic activity.

In January 2001, the President signed the Decree on the Decision of the National Security and Defense Council of Ukraine on Measures to Bring the Economy out of the Shadows. The Decree directs the Cabinet of Ministers and newly formed Interdepartmental NSDC Commission for Financial Security to implement a program on the Main Principles of Bringing Money Circulation Out of the Shadows (Kazansky 2001).

In an interview with a Kiev-based daily newspaper in April 2001, the Deputy Secretary of NSDC, Trokhym Kovalchuk, indicated that the government has learned that it cannot combat informal economic activity with strict rules and supervision, but that it must work to create conditions that favor formal, or legally conducted, economic activity. For example, the government recently abolished Article 80 of the Soviet Criminal Code that required punishment for individual possession of foreign currency.

Mr. Kovalchuk explains that the legal and regulatory framework of business in Ukraine requires additional improvements to reduce the informal economy. Several tax loopholes exist, and one is the cause of major outflows from Ukraine. For example, the interest paid on a business loan is considered part of production costs, so is exempt from taxation. Some large businesses have established offshore counterparts to lend money to Ukrainian firms at high interest rates, so they can transfer vast sums of money out of Ukraine under the guise of repaying a loan.

Mr. Kovalchuk reports, "For instance, US budget expenditures, worth \$500 billion, include \$9 billion (1.8%) appropriated by Congress as tax privileges. In contrast, Ukraine grants annual privileges of UAH 30 billion, which exceeds total revenues...none of the supervising bodies can show a complete list of the privileged and assess their true incomes because, officially, nobody in Ukraine is authorized to grant privileges." (Kazansky 2001).

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## ANNEX 1: KHARKIV INVESTMENT INCENTIVES

The Law on Special Investment Conditions in the Territory of the City of Kharkiv provides various tax exemptions for high-priority investment projects in the City of Kharkiv. Under this Law, entrepreneurial subjects that have been registered for at least thirty years in the City of Kharkiv and whose investment projects meet minimum value requirements (see table below) are exempt from import taxes on goods that are used for their own production needs, including materials and raw materials and equipment and its components. The types and volumes of exempted materials and raw materials are listed by the Council for Special Investment Conditions, the overall regulator of special investments in Kharkiv. Qualified entrepreneurial subjects also are exempt from the land tax on site planning and construction, as well as VATs on qualifying equipment and its components. These special conditions apply for the duration of qualified investment projects, to a limit of five years.

New, restructured and reconstructed enterprises that implement investment projects are completely exempt from profit taxes during the first three years of investment, then are subject to a profit tax rate that is fifty percent of the existing rate during the fourth, fifth and sixth years of investment. This profit tax exemption is applied from the moment when the enterprise generates its first profit.

For the purposes of taxation, the gross income of enterprises excludes investments (tangible and intangible assets, other resources) received for qualified investment projects. These privileges do not apply to activities financed by public sources, including the State Innovation Fund.

<b>Legal Definition of High-priority Investments Eligible for Special Investment Conditions in the City of Kharkiv</b>	
<b>Sectors</b>	<b>Minimum Value of Investment (US\$ millions)</b>
Metallurgy and metal processing Machine-building and equipment Electric, electronic and transportation equipment	3.0
Electric energy Gas and water Coke Other non-metal mineral products Transport Communication Metal waste processing	1.0
Construction Sewage Street refuse collection and waste processing Chemical manufacturing Furniture manufacturing Pulp-and-paper and printing industry	0.7
Food industry and agricultural products processing Textiles and clothes manufacturing Tannery and apparel Education Health care Social support R&D in the area of natural and technical sciences	0.5

## **ANNEX 2: LIST OF ACTIVITIES REQUIRING A LICENSE, FROM THE LAW ON LICENSING CERTAIN TYPES OF ECONOMIC ACTIVITY**

1. Geophysical prospecting
2. Cold steel manufacturing;
3. Explosives manufacturing;
4. Dangerous chemicals manufacturing;
5. Uranium ores mining;
6. Precious metals and stone mining;
7. Precious metals and stone manufacturing;
8. Jewelry manufacturing and sales;
9. Medicines manufacturing and trade;
10. Veterinary medicines manufacturing and trade;
11. Pesticides and agrochemicals manufacturing and trade;
12. Tear gas and other chemical weapons manufacturing;
13. Wire taps and other secret information-gathering devices;
14. Cryptographic equipment manufacturing, trade or use;
15. Holographic protective device manufacturing, trade or use;
16. Projecting, manufacturing, application, maintenance, effectiveness research of systems and devices of technical protection of information, services supply in the field of technical protection of information;
17. Manufacturing of securities and other investment products;
18. Transit of oil, oil products using pipe lines, transit of natural gas and oil gas using pipe lines and their distribution;
19. Natural gas supplies according to the regulated, non-regulated tariff;
20. Natural gas storage in volumes exceeding the level established by the licensing terms;
21. Centralized water supply and drainage system;
22. Projecting, researches, manufacturing, exploitation of launch vehicles, space apparatus and their components, land space infrastructure and its components, equipment that is part of space segment of satellite systems;
23. Projecting, manufacturing, production, storage, buying, acquisition, carriage, import, export, sales, termination of drugs, psychotropics;
24. cultivation, utilization of plants containing drugs in industry;
25. Carrying out of disinfecting, disinsection, deratization works;
26. Medical practice;
27. Donors' blood and its components processing;
28. Veterinary practice;
29. Gambling houses;
30. manufacturing, erection of load-carrying structures, erection of structures in the field of construction;
31. Services supply in air transport of passengers and cargoes;
32. Services supply in river and sea transport of passengers and cargoes;
33. Services supply in auto transport of passengers and cargoes;
34. Services supply in railway transport of passengers and cargoes;
35. Storage, processing, scrap ferrous and non-ferrous metal processing;
36. Picking, preprocessing of outcasts and scrap of precious metals and precious stones, precious organogenic stones, semiprecious stones;
37. Storage, processing of some kinds of resource precious wastes, picking, storage of some kinds of wastes as secondary raw materials (according to the list determined by the Cabinet of Ministers of Ukraine);
38. Operations in the sphere of hazardous waste handling;



- 39.** Education services supply to general, technical, higher educational institutions;
- 40.** Projecting, assembling, maintenance of fire protection devices;
- 41.** Fire risk test of materials, buildings, products and equipment, fire engineering, fire prevention production;
- 42.** Supply of state or other property guard services, bodyguard services supply;
- 43.** Carrying out of topographic, geodesic, cartographic works;
- 44.** Carrying out of aerochemical works;
- 45.** Money transfer;
- 46.** Radio communication services supply (using radio frequencies);
- 47.** Telecommunication services supply (with the exception of department objects);
- 48.** Maintenance of telecasting, radiocasting, cable nets in limits of industrial exploitation;
- 49.** Organizing of foreign, domestic, excursion activity;
- 50.** Sports and health activity;
- 51.** Production of ethyl, cognac, fruit spirit, alcoholic drinks, wholesale trade of ethyl, cognac, fruit spirit, wholesale and retail trade of alcoholic drinks;
- 52.** Tobacco products manufacturing, wholesale and retail trade of tobacco products;
- 53.** Insurance activity;
- 54.** Activity of persons, who are responsible for arbitration (property managers, readjustment managers, liquidators);
- 55.** Mediation on employment abroad;
- 56.** Professional activity on the securities market;
- 57.** Organizing of the use of land, valuation of land;
- 58.** Projecting, construction of new and reconstruction of existing land-improvement systems and separate objects of engineering infrastructure;
- 59.** Activity connected with fishery on the fish industry enterprise ponds (with the exception of inner ponds of enterprises);
- 60.** Mediation activity of the custom broker and custom transporter.